Peter Boettke on Omar Azfar's, "The NIE Approach to Economic Develoment: An Analytic Primer."

Azfar provides a good discussion of the major contribution that New Institutionalism has to offer to the political economy of economic development. The main upshot of the debates over the past 20 years is that macroeconomic analysis is not sufficient for understanding the process of economic development. Moreover, standard microeconomic theory assumed the institutional framework as fixed and given. However, in transition economies and the developing world more generally, it is the institutional framework that is under examination and thus we cannot assume it to be fixed and given.

In a new book manuscript on Russian reforms, Axel Leijonhufvud sums up the problem we have had in examining the political economy of transition when he states that reformer's seem to have gotten Adam Smith's 'invisible hand' but not his 'moral sentiments', and Hayek's 'spontaneous order' but not his constitutionalism. Analysts utilizing a new institutional research program would be less likely to commit this error – at least that is the promise of the research program. Azfar, like myself, believes in that promise and does a nice job in this paper providing "good reasons" why that belief is not merely a "faith."

I think the paper could be strengthened considerably, however, if it made explicit recognition of the following points and results in the literature:

(1) Aid work in countries with good governance, and doesn't work in countries with bad governance. In countries with bad governance, all foreign aid does is sustain existing inefficient arrangements and in so doing undermines the necessary reforms. In countries with good governance, aid is effective, but in a certain fundamental respect could be said to be unnecessary.

(2) Growth is good for the poor. The gains from growth go to the poor more than the rich in a reforming economy. This result is found in David Dollar's study and also in Carol Graham's study of safety nets in reforming economies.

(3) We know more about (a) non-convergence, and (b) the institutional reasons now than we did 20 years ago because of the empirical work in modern growth theory. I would like to see Azfar address the work by Hall/Jones (QJE) and in particular the recent Acemoglu, Johnson, and Robinson paper (AER, Dec. 2001). In addition, the work by Mahoney (JL&E) on common law countries and growth, and the several papers by Shleifer on institutions and finance should be consulted.

(4) Azfar raises the capabilities approach of Sen (and to a lesser extent Martha Nausbaum). I think Sen raises good points, but an examination of the data does reveal that the stark contrast that Sen likes to draw between growth and

capabilities is just not there. Capabilities are more or less positively correlated with increases in per capita income. This point should be recognized.

(5) With regard to New Institutional Economics, I like the survey but would stress the following:

a. New Institutionalism highlights incentives and *information*. And in particular, rather than the usual market failure story, the introduction of imperfect information into the analysis does not lead to inefficiencies. Markets, in fact, are driven by asymmetric information. Today's inefficiency is tomorrow's profit for the entrepreneur who is alert to the opportunity for mutual gain. Institutions, from this perspective, serve as mediators and enable actors to transform self-interest into social order. Self-interest is omni-present, social order is not --- it takes the incentives structures and the informational component of certain institutions (namely private property, freedom of contract and the rule of law) to translate self-interest into a prosperous social order.
b. It is commonplace to divide New Institutionalism into Neo-institutionalism and New Institutionalism. In neo-institutionalism the behavioral postulates of mainstream economics are maintained and institutions are treated as a sort of budget constraint. In New Institutionalism, on the other hand, a bounded rationality model substitutes. This distinction is found in the T. Eggerstton, Economic Behavior and Institutions. Two new books which I highly recommend are M. Aoki, *Comparative Institutional Analysis*, and Kasper and Streit, *Institutional Economics: Social Order and Public Policy*.
c. One of the main missing components of Institutional economics is entrepreneurship – in both its arbitrage (Kirzner) and innovative (Schumpeter) variety. Fundamentally, with regard to development entrepreneurship is really an issue of betting on an idea and being able to find the financing to bring those bets to life. This brings up Olson's emphasis on PREDATION. Azfar could have spent more time examining the institutions that ward off predation and in particular the question of credible commitments to enforcement mechanisms. I have addressed this issue in a few papers reprinted in my recent collection, CALCULATION AND COORDINATION. For markets to grow and prosper the institutional matrix must support anonymous interactions (what Olson referred to as contract intensive measures).
d. Finally, in the discussion we talked about the issues of corporate governance. Williamson's work obvious raises these issues of governance to the forefront of any analysis. In my own work, I have developed a variant of Williamson's hostage model to address questions of commitment devices in policy in general. But the issue of *corporate* governance is different in my opinion. What we should have learned from economic history and the experience of transition economies, contra writers such as Roman Frydman, is that corporate governance is an

outcome of the market process, not a condition that has to exist prior to the evolution of markets.